IN THE

Supreme Court of the United States

October Term, A. D. 1925

No. 67

BURK-WAGGONER OIL ASSOCIATION,
Plaintiff in Error,

VS.

GEORGE C. HOPKINS, Collector of Internal Revenue,
Second District of Texas,
Defendant in Error.

In Error to the District Court of the United States for the Northern District of Texas.

PETITION FOR RE-HEARING

BY PLAINTIFF IN ERROR.

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Office Supreme Court, U.
FILED
DEC 28 1925
WM. R. STANSBURY
CLERK

Office Supreme Court, U.
FILED
FEB 1 1926
WM. R. STANSBURY
CLERK

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TO THE HONORABLE, THE SUPREME COURT OF THE UNITED STATES:

Burk-Waggoner Oil Association, plaintiff in error in this cause, respectfully moves this Honorable Court to set aside the opinion and judgment rendered herein on November 16, 1925, and to reverse the decision of the District Court in this cause. Supporting this motion, plaintiff in error respectfully says:

THE COURT ERRED IN HOLDING THAT CONGRESS COULD DISREGARD STATE LAWS REGARDING THE OWNERSHIP OF PROPERTY AND THE RIGHTS OF TAXABLES THEREIN IN IMPOSING INCOME TAXES.

THE COURT ERRED IN HOLDING THAT THE AMOUNT TAXED IN THIS CASE WAS INCOME EARNED IN THE NAME OF THE ASSOCIATION.

This Court, in the opinion delivered in this case, after agreeing with the contention of the plaintiff in error that the Burk-Waggoner Oil Association was not an entity but was under the laws of Texas a partnership, went on to say:

> **"But the thing to which the tax was here applied is confessedly income earned in the name of the association.** * * * The power of Congress so to tax associations is not affected by the fact that, under the law of a particular state, the association cannot hold title to property, or that its shareholders are individually liable for the association's debts, or that it is not recognized as a legal entity. **Neither the conception of unincorporated associations prevailing under the local law,** nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders **is of legal significance as bearing upon the power of Congress to determine how or at what rate the income of the joint enterprise should be taxed."**

Assuming, for the purpose of this motion, that Congress intended to tax those associations which were partnerships as corporations, it follows that Congress intended to treat such associations as entities and to tax them

as such. We understand from the opinion in this case that this Court has approved this attempt and that the effect of the opinion is to say that, although the enterprise involved is technically a partnership and for all other purposes the courts will recognize that the members have the same rights in the property as other partners have, Congress is at liberty to disregard these property rules and to tax the enterprise as an entity, and to say that the profits made jointly by the members constitute, for income tax purposes, the profits of a taxable entity. This is only another method of saying that Congress can disregard ownership and property rules in levying income taxes.

Assuming this to be the Court's attitude, let us, at the risk of tediousness, state what we understand to be the difference between an association which is not an entity and an association which is an entity. In those associations which are not entities, as, for example, the ordinary partnership, the property which constitutes the capital of the group is owned by the members of the group. They have direct ownership of undivided interests in the property so that, disregarding for the moment restrictive agreements which they may have made with each other, one member can sell and convey to a third person an undivided interest in the property and he can convey this interest free and clear of the claims of unsecured creditors of the enterprise. In such a case, the obligations incurred are the direct, primary obligations of the members and the members are not secondarily liable. The members of the group at any particular time constitute, as of that time, the "actual and ultimate proprietors of the property." (Thompson vs. Schmitt, 114 Tex——, Brief for plaintiff in error, p. 28). **Each member of the group owns an undivided interest in the prop-**

erty as a tenant in common. (Hoadley vs. County Commissioner, 105 Mass. 519). Any right which creditors of the group might assert to have the joint assets applied to the payment of their debts is a right derived only through the right which the other members have to see that this is done. This derivative right cannot be exercised except by and through the other members. **When the other members have foregone this right, bona fide, creditors are precluded.** (See in this connection Case vs. Beauregard, 99 U. S. 119; Fitzpatrick vs. Flannigan, 16 Otto 648, 106 U. S. 648; Huiscamp vs. Moline Wagon Company, 121 U. S. 310; Dakota Trust & Savings Bank vs. Hansen, 5 Fed. (2nd) 915, (8th C. C. A.) **In short, where the group is not created into a legal entity under local law, each member has identically the same property interest in the property, to the extent of his proportionate interest, as he would have if he were the sole owner of the whole.** The agreement between him and and his associates is merely a contract and does not affect the gain which he derives from the property, during ownership, any more than a contract of rental with a tenant, an option to sell or any other similar contract would.

On the other hand, if the enterprise is an entity, as, for instance, a corporation, the stockholder or member has no interest whatsoever in the property of the corporation as such. His only right in the property is to have it applied to the purposes for which the entity was created and to receive pro rata, when the dividends are declared or upon dissolution, the earnings and capital. When he sells the share, he sells this right and not an interest in the property. From the inception to the termination of the enterprise, it is looked upon as entirely separate from its stockholders, so that changes in the ownership of shares have no effect upon it whatsoever.

The liability of members for debts is always secondary.

We may say, parenthetically, that whether or not the members of either sort of enterprise are liable for its debts in any way is of itself a matter of no importance in determining how the income from the enterprise can be taxed. It is important only as an aid in determining from the nature of the liability whether or not an entity exists. An entity cannot exist where there is a direct primary liability upon the part of members for all obligations.

It is certainly clear that whether an enterprise is or is not an entity is a question governed entirely by the laws of the state where the enterprise exists. In the present case, whether or not the enterprise is an entity is important in determining whether or not the members own the property directly or have merely a right to the benefits derived from the use of the property. We take it that it will not be contended that the Legislature of the State of Texas could not, if it saw fit, pass a law abolishing the principle or theory of corporate entity and providing that thereafter corporations will be considered merely as groups of individuals, so that the holder of a share of stock in a corporation should own an aliquot portion of the corporate assets. On the other hand, we believe that the Legislature of the State of Texas could enact that associations are entities; that the rights of the owners of shares would be merely to have the assets applied to associate purposes and to receive, upon dividend or dissolution, their pro rata part of the earnings and capital. **In other words, the rights of members of either sort of enterprise are fixed by the laws of the state where the enterprise exists; a partnership can be made into an entity or a corporation made into merely a joint enterprise by the will of the legislature.**

But, when the law regarding the rights of members has been fixed by the state in which the enterprise exists, we submit that it is binding even upon Congress when Congress is dealing with a subject in which property rights are necessarily involved. If Congress must recognize the fact of corporate entity in levying income taxes, it must recognize the absence of entity in levying income taxes. The same constitutional provisions which forbid destroying or disregarding forbid creating an entity.

That Congress cannot disregard the fact of entity and the resulting property rights for income tax purposes has been definitely determined by this Court, and this is in direct conflict with the statement in the opinion in this case that the concepton of unincorporated associations prevailing under the local law is of no significance in determining how the enterprise can be taxed. In Eisner vs. McComber, 252 U. S. 189, this Court held that a stock dividend declared by a corporation did not constitute taxable income or a taxabie dividend to the shareholder receiving same. This decision is founded upon the corporate entity theory and this, in turn, is founded upon state law. Congress had in express terms declared that, "A stock dividend shall be considered income, to the amount of its cash value." This Court said: (page 208)

> **"Can a stock dividend, considering its essential character, be brought within the definition?** (The definition of income). To answer this, **regard must be had to the nature of a corporation and the stockholders' relation to it."**

May we ask by what law, other than the law of the state where the corporation was chartered, the nature of the corporation can be determined or the stockholders' relation to the corporation can be ascertained? **Con-**

gress has never attempted to legislate upon such a subject and unquestionably could not. The Court went on to say that the fact that profits had been made and not divided did not give: (page 209)

> "To the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for that purpose."

And the opinion continued: (page 214)

> "But, looking through the form, **we cannot disregard the essential truth disclosed, ignore the substantial difference between corporation and stockholder, treat the entire organiaztion as unreal, look upon stockholders as partners, when they are not such,** treat them as having in equity a right to a partition of the corporate assets, when they have none, and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. **We must treat the corporation as a substantial entity separate** from the stockholder, not only **because such is the practical fact** but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income to the stockholder."

This Court said that Congress could not treat stockholders as partners, could not ignore the separate entity; but obviously the legislature of the state where the corporation was created could make of the shareholders partners and could destroy the corporate entity. **In oth-**

er words, this Court in the McComber case held that Congress was bound by the rules of ownership with respect to corporate property and by the fact of corporate entity in levying income taxes.

That this is true is further shown by the fact that, later in the opinion, the Court overruled the case of Collector vs. Hubbard, 12 Wallace 1. In the second argument of the case, the Government contended that, by the true construction of the Act of 1916, a tax on stock dividends was imposed, not upon the stock dividend, but rather upon the stockholder's share of the undivided profits previously accumulated by the corporation, the tax being levied as a matter of convenience at the time such profits became manifest through the stock dividend. The Court said with respect to this: (page 218)

> "That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question, and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this Court."

The opinion then went on to say that the Government relied upon Collector vs. Hubbard, which dealt with the Act of June 30, 1864, providing that:

> "The gains and profits of all companies, whether incorporated or partnership, other than companies specified in that section, shall be included in estimating the annual gains, profits, or income of any person, entitled to the same, whether divided or otherwise."

Collector vs. Hubbard had upheld this system of taxation and it was overruled in the following language: (pages 218, 219)

> "Insofar as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by Pollock vs. Farmers Loan & Trust Company, 185 U. S. 601, 627, 628, 637. Conceding Collector vs. Hubbard was inconsistent with the doctrine in that case, because it sustained a direct tax upon property not apportioned among the states, the Government nevertheless insists that the 16th Amendment removed this obstaccle so that now the Hubbard case is authority for the power of Congress to levy a tax on the stockholder's share of the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. Manifestly this argument must be rejected, since the Amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. **As we have pointed out, a stockholder has no individual share in accumulated profits nor in any part of the assets of the corporation, prior to dividend declared."**

And we add to this that a stockholder had no individual share in accumulated profits, nor in any particular part of the assets of the corporation, simply and only because the laws of the state where the corporation is chartered so provided.

Can it be said that, if the state law had provided that Mrs. McComber had an individual share in the accumulated profits of the corporation and a right to demand that share, this court would have held that she could not have been taxed on this stock dividend? Cer-

tainly not! But whether she has such share depended upon state law, and her rights could have been altered by state law. The conception of corporations under the local law governed the case.

Therefore, we respectfully say that so much of the opinion as states that the conception of unincorporated associations prevailing under the local law is of no importance in determining the power of Congress to tax such associations is directly in conflict with the case of Eisner vs. McComber. The case of Eisner vs. McComber announced the correct conception of the limitations existing upon the power of Congress to define and tax income, and that so much of the opinion in this case as conflicts therewith is in error.

Passing to that portion of the Court's opinion which states that the thing to which the tax was here applied "is confessedly income earned in the name of the association," we would respectfully direct the Court's attention to certain undisputed facts disclosed by the record. The profit taxed was $1,838,053.90; of this sum $1,813,488.94 was the profit, so-called, shown in the tax return from the sale of the oil and gas lease which constituted practically the entire capital of the group. This "profit" was arrived at by the following calculation:

Selling price		$2,000,000.00
Cost of property	$ 40,000.00	
Subsequent improvements and expenses of sale (net)......	146,511.06	
Total cost		186,511.06
PROFIT		$1,813,488.94

(See copy of original tax return in the printed rec-

ord between pages 40 and 41). The remaining profit reported of $24,564.96, was derived from the production of oil, but, for the purpose of this motion, will be disregarded. This $40,000.00 cost of the lease represents the amount of stock issued for same. (See Article XVI, Articles of Association, Rec. p. 21). There were six hundred shares of the capital stock outstanding and these shares were freely transferred. (Rec. p. 24). Certain of the shares cost the final owner thereof, Clois L. Greene, as high as $2,950.00 per share. (Rec. p. 51). The Articles of Association show that there were eleven people interested in the enterprise at its inception and the testimony shows that about two hundred people ultimately owned shares therein. (Rec. p. 54).

The liability which Congress imposes upon associations of this character for income and excess profits taxes is imposed upon the holders of the assets at the time the tax liability accrues, which in no case can be before the end of the taxable year and is probably the date when the association's tax return is made. If one person bought a share in the enterprise when the assets of the association were worth enough so that the stock was worth par and paid par therefor, and subsequently the association was successful so that this shareholder sold this stock to another person at an increased price, the shareholder so selling would be under no liability whatsoever to the United States for any portion of the income and excess profits tax imposed upon the association. But Congress does impose the liability upon the shareholder at the time the liability for tax accrued, and does not attempt to give this last shareholder any right to recoup any part of the tax from his predecessor in ownership. The tax here dealt with is not, and does not purport to be, a tax lev-

ied in part against the preceding owner of the shares, but is levied on the final owner.

This Court has decided that under the state law this enterprise is a partnership, technically at least, that it is not an entity; and it is certainly true that the shareholders are the "actual and ultimate proprietors of the property" and that they own the property in undivided interests, as tenants in common. **It necessarily follows from this that when a share was transferred, there was transferred, in fact and law, from the seller to the purchaser an undivided interest in this oil and gas lease which at all times constituted the bulk of the associate assets.** If the enterprise is not an entity, it can only be a group of persons. With a change in the ownership of one share, it is a different group or a different association from that which it was immediately before the transfer of such share, just as a change in the membership of any partnership makes a new partnership. So, when each share changed hands there was a new association. **When the share changed hands at more or less than par, there was a variation in the cost of the purchaser's interest in the oil lease and a consequent variation in the total cost to all of the then owners.** The multiplication of this single process at varying prices gives to the last owners varying costs to their respective interests, and a very different cost than the original $40,000.00 as the total cost for all of the owners at the date of sale, at the close of the year 1919, and at the time the tax return was made. Every person who had sold his interest in the enterprise, or his shares therein, was "out of it" and he was not subjected to any part of the tax here in controversy (although, of course, he was taxed upon his individual profit and this will be referred to hereinafter).

Therefore, we say, **"the association" taxed was the group of individuals who at the close of the year 1919 owned the money from which the amount of the tax was taken and paid.** Since this is true, can it be said that the amount taxed was income "earned in the name of the association?" In other words, was it income earned in the names of the persons who were shareholders at the close of the year 1919?

It is a settled principle that the profit derived from the sale of property cannot exceed the difference between cost and selling price. In fact, this Court has very recently in the case of United States vs. Flannery, et al 268 U. S. 98, decided April 13, 1925, re-announced the proposition that **in no case can the profit or loss from the sale of property exceed the difference between cost and selling price,** and reaffirmed similar determinations made in Goodrich vs. Edwards, 225, U. S. 527, and Walsh vs. Brewster, 225 U. S. 536; see also McCaughm, Collector, vs. Ludington, 268 U. S. 106, decided April 13, 1925. Under these decisions, if a man purchased the fee simple title to a piece of real estate for $10,000 and sold it for $20,000, under no circumstances can he be taxed upon more than $10,000, for that is the ultimate gain which he could have derived from the transaction, and there can be no income without gain. We assume that no argument is necessary to support the proposition that this Court would not uphold Congress in taxing such a person under such circumstances upon the difference between what the property cost the person who sold it to the person taxed and the selling price which the taxpayer received. To illustrate, A purchased a lot for $1000.00 and sold it to B for $10,000.00; B sold it to C for $20,000.00. Would this Court permit B to be taxed upon a profit measured by the difference between the cost to A

and the selling price to C? Can it be said that B received more than a gain of $10,000.00? Would this Court permit him to be taxed upon a so-called gain of $19,000.00? We assume that these questions must be answered in the negative.

Can it be said then that the situation would be different if B bought an undivided one half interest in the property from A and D bought the other undivided one half interest from A, and they then sold jointly to C; the aggregate prices in all cases being the same as in the preceding example? Can the profit of B and D be said to include A's profit, any more than if B had purchased the entire property from A and had had no associate therein? What is true in the one case would certainly apply in the other. Likewise, the situation would not be changed because B and D might have acquired their interest at varying times, or because one might have paid proportionately a larger price than the other.

Whether B and D be taxed separately or jointly, the gain to them separately or jointly from the sale of the property cannot exceed the difference between the sums which they paid for their respective interests and the sums which they received for their respective interests. Congress has no more right to alter or define the conception of income in this respect than it had with respect to stock dividends.

This is a question, not of the power to tax them jointly, but of the power to say that their joint "income" subject to a direct unapportioned tax, is more than their joint gain. This power is expressly denied in the McComber case.

The preceding examples illustrate exactly what happened in calculating the tax liability in this case. Some

eleven men jointly acquired title to an oil and gas lease at a cost of $40,000.00. Other people acquired for varying sums interests therein from them and these original shares were sold from time to time to various persons and for varying amounts, one or more of the shares of one of the final owners costing $2,950.00.

If there had been no changes in the ownership of shares from the beginning to the end of the enterprise, it might well be said that the amount taxed was income earned in the name of the association. But this did not happen. Original and intermediate owners sold out, took their money, and withdrew from the enterprise; people purchasing from them paid increased prices over the cost to the original owners and became members of the association; **and those that held on until the last constituted "the association" taxed in this case. The tax was actually imposed upon individuals, not upon an entity.**

To go back and to tax these last owners upon a so-called "profit" measured by the difference between the cost to the original owners and the final selling price is the exact equivalent of going back (in the example above given) and taxing B and D upon a profit measured by the difference between the cost to A and the selling price to C. **This is true because there was no entity, because the owner of a share at any particular time owned an undivided interest in and to this oil and gas lease; when he sold his share, he sold an interest in this oil and gas lease, so that the gain of the persons taxed,** even though it be conceded—which we do not concede—that they can be taxed as a group, **cannot exceed the difference between the aggregate cost of the shares to the last owners and the total selling price,** for when they sold the lease in its entirety, each sold (and must necessarily have sold since he was a joint owner) his interest therein.

It is true that some of the original owners probably held their original stock until the last, but others did not, as the record positively discloses; and the principle is the same even if only one share had changed hands at an advanced price. Since Greene purchased the share which cost the original owner only $100.00 for $2,950.00, it is just as unconstitutional and illegal to disregard $2,850.00 of his purchase price as it would be had the entire amount of the shares changed hands at $2,950.00 per share.

Let us assume that this last actually happened: The six hundred shares at $2,950.00 amount to $1,770,000.00, an increase over the cost price used in calculating the tax liability of $1,730,000.00. If one or more persons had purchased all of the stock for this $1,770,000.00, unquestionably he or they would have thereby acquired title to the entire oil and gas lease. If they had re-sold the same for $2,000,000.00, his or their actual profit would have been $1,730,000.00 less than the amount upon which the tax was based. Under the cases above cited, no more than the difference between this cost and this selling price could have been taxed.

These same rules apply, even though there was in effect a contract calling for the continued existence of the enterprise. The tax liability cannot be made to depend upon this feature of the Articles of Association. An unincorporated Association can easily be formed where one or more members have the right at all times to terminate the existence of the relationship. Would this Court say that such an association could not be taxed in the same way the Burk-Waggoner Oil Association was? If it could be, the dedication of the property to certain uses for a certain period, at all times subject to termination by the will of the majority, has no bearing on the question of tax liability.

We believe that we have hereby demonstrated not only that the method used by Congress and upheld by this Court taxes income to persons other than owners, but we submit that we have demonstrated with mathematical certainty that the income taxed was much more than actual gain; that this group of last owners was taxed merely because they owned property of a certain value under certain restrictions, and not because they had made any given amount of profit. That such a tax "would require apportionment under the provisions of the Constitution is settled beyond peradventure by previous decisions of this Court." (Eisner vs. McCumber, supra.)

The essence of the situation is that Congress has taxed the gain of the original owners, the intermediate owners, and the final owners to the final owners and has not afforded the final owners the right to recoup themselves from their predecessors in ownership.

This proposition is not to be answered by asserting that the ultimate owners purchased their interests with knowledge that the Government would assert a tax liability, and therefore they should not be heard to complain. Admittedly, one may not complain where it is merely a question of misunderstanding the liability imposed by the law; but that is not the question. The members of this group have no right to complain of any tax which Congress might have levied upon their profits, even though they may have misunderstood the nature and amount of the tax. But under the Constitution they do have the right to complain when they are subjected to an income tax upon an amount which greatly exceeds their aggregate or several incomes.

Income exists independently of the view of the tax-

able or the pronouncement of Congress. When it actually exists, Congress can tax it without apportionment. When it does not exist, and it cannot exist without, or exceed, gain, this right is gone.

In the light of the above, we respectfully call the Court's attention to that portion of the brief for plaintiff in error which deals with the question of double taxation. This was not mentioned in the Court's opinion, but we would respectfully point out that the feature of double taxation was sufficient in the case of Crocker vs. Malley, 249 U. S. 223, to have this Court declare that the enterprise there involved was not an association subject to the taxes imposed upon corporations. We believe we are correct in stating that, under the decision in Hecht vs. Malley, 265 U. S. 144, this Court would declare the enterprise involved in the Crocker case an association for excise tax purposes, when no feature of double taxation is involved.

Let us assume an association in which A bought a share for $100.00, which share was then sold to B for $500.00; the assets of the enterprise were then sold so that B's pro rata portion was $1000.00, and upon this profit from the joint sale a tax equal to $200.00 per share was levied and collected from the associate assets and the balance of $800.00 then distributed to B. The Government would collect the following income taxes upon this transaction: A would be taxed individually upon his profit of $400.00, the difference between his cost and selling price; B would then contribute his pro rata part to a tax based upon the difference between a cost of $100.00 per unit of interest in the assets and a selling price of $1000.00, although his cost was actually $500.00; in other words, he would pay a tax upon his profit plus A's profit; then upon distribution B would be taxed in-

dividually upon the difference between the $500.00 cost of his share and the $800.00 received upon liquidation. This is more than double taxation—it is treble taxation. And, with more intermediate ownerships between A and B, it is more than that.

We re-affirm the statements heretofore made that the method of taxation applied to unincorporated associations in truth and in fact taxes various individuals in the same amount, although the income of one may be much greater than the income of the other, and although some of them may have no income from the particular transaction or from the total of their transactions.

Since practically all of the profit here involved was derived from the sale of an oil and gas lease, which is real estate under the laws of Texas, unquestionably the tax here involved is a direct tax and comes within the constitutional requirement of apportionment when not levied upon income, in the constitutional sense.

It was suggested at the oral argument of this case that many of the results which are deprecated by plaintiff in error likewise apply to corporations. Admittedly, from a practical standpoint this is true. Likewise it is true that from a practical standpoint, a business man recognizes no real distinction between the placing of undistributed earnings into the capital account of a corporation and the issuance of a stock dividend thereon, and the placing of the same amount to the surplus or the undivided profit account of a partnership. He considers that his financial worth has been increased in the one case as much as in the other. But there is a difference, which this Court has distinctly recognized, between the two situations—a difference of sufficient importance to have warranted this Court in holding an express

provision of the Revenue Act of 1916 unconstitutional. (Eisner vs. McComber). This principle is the principle of corporate entity, and this principle and fact of corporate entity furnish the legal justification for Congress, if it sees fit, to impose these additional hardships upon corporations and stockholders therein. The existence of this same legal principle removes the question of determining the propriety of imposing these hardships and injustices in the case of corporations and stockholders from the judicial to the legislative field. **But that these hardships can lawfully be imposed in one case by virtue of a certain principle, affords no justification for this Court upholding their imposition in another case where the same legal princiiple is not involved and where the benefits, which ordinarily follow the fact of incorporation and afford some additional justification for imposing these additional hardships, are not granted.**

In conclusion, we respectfully say that the laws of the state in which the taxpayers reside and in which the property involved is located have much more than "legal significance" as bearing upon the power of Congress to determine how the persons gaining income from the property can be taxed—they are absolutely controlling. By them alone can it be determined to whom interest belongs, to whom the rent from real estate belongs, what wages are and who has received them and to whom they belong. Disregarding the laws of property in the state would permit an agent to be taxed upon money received for his principal, or a bank to be subjected to an income tax based upon the amount of its deposits, and many other results equally inconsistent with the settled principles announced by this Court. And we further submit that no single individual, nor any group of individuals when

the group does not constitute an entity, can be subjected to an unapportioned income tax upon a so-called profit derived from the sale of property, the amount of which exceeds the difference between the aggregate cost and the aggregate selling price of the property.

If these statements are correct, then we submit the position taken in the original brief is unassailable; and this case should be reversed.

Respectfully submitted,

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AUTHORITIES

In the Supreme Court of the United States

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BURK-WAGGONER OIL ASSOCIATION, PLAINTIFF IN error

v.

GEORGE C. HOPKINS, COLLECTOR OF INTERNAL REVENUE, Second District of Texas

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IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF TEXAS

BRIEF FOR THE DEFENDANT IN ERROR

The report of this case in the court below is found in 296 Fed. 492, and the opinion is printed in the Record, pages 4 to 12.

JURISDICTION

The plaintiff in error sued the Collector of Internal Revenue in the District Court to recover $145,827.67 paid as income and excess-profits taxes and interest thereon for the year 1919 under the Revenue Act of 1918 (Act of February 24, 1919, c. 18, 40 Stat. 1057), alleging that the taxes were unlawfully assessed and were paid under protest

and that claim for refund had failed. The amended petition was filed February 21, 1924. (R. 1.) The case was tried by the court without a jury, pursuant to written waiver, and resulted in a judgment, filed March 3, 1924, in favor of the defendant. (R. 12.) The case was tried upon an agreed statement of facts (R. 14), and in addition the testimony of one witness was taken (R. 49). The opinion of the court sets forth briefly (R. 5–7) the essential facts, and the entire stipulation of facts was incorporated in a bill of exceptions (R. 14 et seq.). A writ of error was allowed and filed on April 21, 1924. (R. 58, 59.)

The jurisdiction of this Court by direct writ of error to the District Court seems to be based upon Section 238 of the Judicial Code, upon the ground that the case involves the construction of the Constitution and the constitutionality of the Revenue Act of 1918.

The Government does not admit this jurisdiction and suggests that no substantial constitutional question is involved and that this Court may well dismiss the writ of error upon the authority of *Sugarman* v. *United States,* 249 U. S. 182; *Piedmont Power & Light Co.* v. *Graham,* 253 U. S. 193; *Wise* v. *Mills,* 220 U. S. 549; *American Sugar Refining Co.* v. *United States,* 211 U. S. 155, and similar cases.

STATEMENT OF THE CASE

The Burk-Waggoner Oil Association was organized on November 15, 1918, by an agreement be-

tween six individuals residing in Texas, which was styled "Articles of Association" and filed in the deed records of Wichita County, Texas. (R. 14.)

Under Article I the organizers "do hereby form an unincorporated joint stock association to be known and styled Burk-Waggoner Oil Association (hereinafter referred to as the company)," which was to continue during the lives of the subscribers and for twenty-one years after the death of the one who died last. Under Article II the general purpose of the "company" was to engage in all branches of the oil business, including the acquisition and disposition of lands. (R. 15.)

The capital stock was $60,000 divided in shares of $100 each to be evidenced by certificates. (Art. III, R. 15.) The certificates were to be issued and signed by the Board of Trustees and countersigned by the secretary of the Board (Art. IV, R. 15), and were to be in the form therein set forth, which contained the provision that no member of said "company" or owner or holder of the certificate should have any authority to transact any busness on behalf of or binding on the "company," and no member of the company should be personally liable upon any contract of any kind or upon any tort of the "company" (R. 16).

The conditions in the certificate were to be binding on each shareholder, his heirs, assigns, and legal representatives. The certificates were to be transferable only on the books of the company and only the shareholders whose certificates stood

in their name would be considered within the terms of the instrument. Any shareholder might transfer his share, and in case of loss or accidental destruction, the trustees might cause a new certificate to be issued. (Art. III, R. 16.)

The shareholders should have no right to any portion of the property or to call for any partition of the property or dissolution of the trust, and the shares should be personal property carrying the right to a proportionate division of the profits, and, upon termination or dissolution, to a proportionate division of the principal. (Art. IV, R. 17.)

The death, insolvency, or bankruptcy of a member, or the transfer of his interest should not work a dissolution or have any effect upon the business nor entitle representatives, heirs, or assigns to an accounting, but the company should remain intact and undisturbed thereby. (Art. VI, R. 17.)

The affairs of the "company" were to be managed by a board of six trustees; the signers of the certificate were to be the first trustees and were to continue until their successors should be elected by a majority of the shares, present or represented at a meeting of the shareholders, which meeting was to be held annually on the first Tuesday in December. The board was to select its president, vice president, secretary, and treasurer and might create such other officers as they might deem necessary to carry on the business of the "company." (Art. VII, R. 17.)

Title to all property acquired should be in the name of the trustees who should hold the same as joint tenants and not as tenants in common, and the trustees might sue and be sued or the "company" might sue or be sued in the company name as provided by the statutes of Texas. (Art. VII, R. 18.)

The trustees were to have full power to conduct the business and affairs of the "company," to borrow money on the credit of the "company," to issue debentures secured by mortgage on the property of the "company." Trustees might fix their own time and place of meeting and the majority should constitute a quorum. Any vacancy should be filled by the remaining members of the board, subject to the right of the shareholders to do so instead, and the board of trustees might from time to time declare and pay such dividends from the earnings of the "company" as they might deem expedient. (Art. VII, R. 18.)

The funds and property of the "company" were to stand primarily charged with the payment of all obligations of the "company" to the end that the members might be protected from personal liability. (Art. VIII, R. 19.)

The board of trustees might adopt by-laws (Art. IX, R. 19) and at any annual or special meeting called for that purpose the shareholders might amend the articles of the association by a three-fourths vote and at any such meeting by-laws

might be adopted, repealed, or amended (Art. X, R. 19). A majority of the shares then issued and outstanding should be necessary to constitute a quorum or to transact business at any such meeting. Provisions were made in Articles XII and XIII (R. 20) for the calling of special meetings of the shareholders voluntarily by the board, or when requested by the holders of one-fourth of the shares outstanding.

The members of the board were at all times subject to the orders of the shareholders, who might, by vote of a majority of the shares then issued and outstanding, remove any or all of them and appoint their successors. (Art. XIV, R. 21.)

$40,000 of the capital stock of the "company" was to be paid for the acquisition of a certain described oil and gas lease, and the balance, $20,000, was to be sold for cash (Art. XVI, R. 21), and the stock of the association might be increased at any time by vote of a majority of all the stock present and represented at a meeting called for that purpose (Art. XVI, R. 22).

The dissolution of the "company" might be effected by vote of the shareholders holding three-fourths of all the shares then issued and outstanding, but not at any time prior to the period fixed for final dissolution, while there should be outstanding against the property any obligations of the trustees secured by mortgage on the property, without the written consent of the holders of two-thirds of the bonds. (Art. XVII, R. 22.)

About two hundred persons were interested, and were certificate holders, in the association and the certificates were traded in generally by the public. (R. 7.)

The lease referred to was assigned to the trustees on December 14, 1918 (R. 25). With funds raised from the sale of the remaining capital stock, an oil well was drilled, which was very productive, and on May 5, 1919, the whole property was sold for $2,000,000. A profit of $24,564.96 was received from the production of oil prior to the sale, and a profit of $1,813,488.94 from the sale of the property, the total profit being $1,838,053.90, all of which was received in the year 1919. (R. 27.)

The total income and excess profits tax assessed was $561,279.20. This was paid in four instalments, the first three being paid to the predecessors of the defendant, against whom suits are pending, and the last instalment, $145,827.66, was paid to the defendant, and it was to recover that payment that this suit was brought. (R. 4.)

The tax was assessed upon the theory that the plaintiff was an association or joint-stock company and taxable as a corporation within the meaning of Section 1 of the Revenue Act of 1918 (Act of February 24, 1919, c. 18, 40 Stat. 1057), which provides that the term "corporation," when used in the act, should include "associations, joint-stock companies, and insurance companies."

The plaintiff now claims that it is a partnership and not taxable as an association.

FURTHER SIGNIFICANT FACTS

In view of the claim now made that plaintiff in error is not to be treated as an association but rather as a partnership, certain other facts shown by the record are significant.

In the first place, the record affords no reason to infer that prior to the institution of this suit the members of this association ever regarded it as anything but an association taxable as such with corporations. The claim now made was not advanced in any of the proceedings to obtain a refund or revision of the tax by the Commissioner of Internal Revenue. The first claim for refund (Ex. A, R. 28) is based upon the contention that the principal item of its income was derived from the sale of capital assets and that such gain was not income within the Sixteenth Amendment. In that claim it is stated (R. 29) "claimant, Burk-Waggoner Oil Association, is an unincorporated joint-stock association, organized with a capital stock of $60,000 on November 15, 1918," and the property which it sold is described as "the company's property."

In the next claim (Ex. B, R. 29, 30) it is referred to as "said company." The claim therein made was that it was entitled to a special assessment under Sections 327 and 328 of the Act of 1918, because "owing to abnormal conditions af-

fecting the capital income of the Burk-Waggoner Oil Association it would suffer exceptional hardship, as is evidenced by the gross disproportion between the tax paid and the tax paid by representative corporations engaged in the same line of business." (R. 30.) It goes on:

> This company contends that it should be compared to representative corporations engaged in the business of producing oil; that it should not be compared only with those which are highly successful. That the term "representative corporation" means substantially average corporations, and that the average of a large number of corporations engaged in the oil business, including the very successful, the unsuccessful, and those between, should be used as a basis of comparison.

It was also contended that the average "small oil company" for the year 1919 made no money, and that the greater number of those operating in that year were then insolvent; that this applies particularly to the locality in which the Burk-Waggoner Oil Association operated, and that the "average corporation" engaged in the business in that vicinity in 1919 paid no excess profits tax.

In the original return (Ex. C) it claimed the benefit of a "discovery" under sections 234(9) and 337 of the excess profits tax law.

In a letter dated March 5, 1920, addressed to the Commissioner of Internal Revenue by attorneys for the plaintiff in error (R. 38) it is again

described as a " joint stock association " and again makes application for a special assessment of its excess profits tax under the provisions of Section 327 of the Act. This letter calls attention to the gross disproportion between the tax computed without the benefit of that section and the tax if computed by reference to " representative concerns." It bases an argument upon reports of the " larger companies," like the Standard Oil Company and the Texas Company, and submits a list of " smaller companies " whose capital " is of approximately the same size as the Burk-Waggoner Oil Association." (R. 40.) Then follows this significant sentence:

> A large number of successful concerns operating in the field operate as partnerships and for that reason their returns can not be compared with the Burk-Waggoner Oil Association. (R. 40.)

The conclusion which the Commissioner was asked to draw was that the excess-profits tax of the Burk-Waggoner Oil Association as computed without the benefit of Section 327 was grossly disproportionate to that of " representative concerns engaged in the same business." All this shows that there was never in the minds of plaintiff's officers or counsel, during the time when refund was being sought from the Treasury, any idea that plaintiff was not taxable as a corporation.

A TEXAS STATUTE

On page 15 of the brief of plaintiff in error there is set forth a statute of the State of Texas, passed in 1907, entitled: "An Act to authorize unincorporated joint stock companies or associations to sue and be sued in their company or distinguishing name and to prescribe the mode and effect of service on such unincorporated companies, and the legal effect of judgments that shall be rendered in such actions, and declaring an emergency."

The provisions of the statute are indicated by its title, and, as the court below aptly said (R. 9): "They come here under section 6149 of the Revised Statutes of Texas, which authorized an association or joint stock company to sue and be sued."

CONTENTIONS OF THE DEFENDANT IN ERROR

Defendant in error contends:

1. That the plaintiff-in-error is, within the meaning of the Revenue Act of 1918, an association or joint-stock company, and therefore taxable as a corporation, and

2. That the case presents no substantial constitutional question to sustain the jurisdiction of this Court by direct writ of error.

ARGUMENT

I

The plaintiff in error is, within the meaning of the Revenue Act of 1918, an association or joint-stock company, and therefore taxable as a corporation

Section 1 of the Revenue Act of 1918 (Act of February 24, 1919, c. 18, 40 Stat. 1057) provides that when used in the act "the term 'corporation' includes associations, joint-stock companies, and insurance companies," and subsequent sections impose upon "corporations" as thus defined income and excess-profits taxes.

The facts already stated show conclusively that the plaintiff in error is an association or joint-stock company within the meaning of the act. The decision of this Court in *Hecht* v. *Malley*, 265 U. S. 144, is ample authority. That case involved the excise-tax provisions of the Revenue Acts of 1916 and 1918, and this Court held that the organizations then before the Court were associations within the meaning of the latter act. Mr. Justice Sanford, speaking for the Court, said, at page 157:

> The word "association" appears to be used in the Act in its ordinary meaning. It has been defined as a term "used throughout the United States to signify a body of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of

some common enterprise." 1 Abb. Law Dict. 101 (1879); 1 Bouv. Law Dict. (Rawle's 3rd Rev.) 269; 3 Am. & Eng. Enc. Law (2d ed.) 162; and *Allen* v. *Stevens* (App. Div.) 54 N. Y. S. 8, 23, in which this definition was cited with approval as being in accord with the common understanding. Other definitions are: "In the United States, as distinguished from a corporation, a body of persons organized for the prosecution of some purpose, without a charter, but having the general form and mode of procedure of a corporation." Webst. New Internat. Dict. (U. S.). "An organized but unchartered body analogous to but distinguished from a corporation." Pract. Stand. Dict., and see *Malley* v. *Bowditch* (C. C. A.), 259 Fed. 809, 812; *Chicago Title Co.* v. *Smietanka* (D. C.), 275 Fed. 60; also *United Mine Workers* v. *Coronado Co.*, 259 U. S. 344, 392, in which unincorporated labor unions were held to be "associations" within the meaning of the Anti-Trust Law.

That the Burk-Waggoner Oil Association is regarded for certain purposes by the courts of Texas as a partnership is immaterial. The organizations considered in *Hecht* v. *Malley* were so-called "Massachusetts trusts." This Court said (p. 147):

> Under the Massachusetts decisions these trust instruments are held to create either pure trusts or partnerships, according to

> the way in which the trustees are to conduct the affairs committed to their charge. If they are the principals and are free from the control of the certificate holders in the management of the property, a trust is created; but if the certificate holders are associated together in the control of the property as principals and the trustees are merely their managing agents, a partnership relation between the certificate holders is created. *Williams* v. *Milton,* 215 Mass. 1, 6; *Frost* v. *Thompson,* 219 Mass. 360, 365; *Dana* v. *Treasurer,* 227 Mass. 562, 565; *Priestley* v. *Treasurer,* 230 Mass. 452, 455.

This court then pointed out the provisions of the trust agreement involved in the case, and it is sufficient to say that, so far as present discussion is concerned, the Burk-Waggoner Oil Association possesses all the elements which made the Hecht, Haymarket, and Crocker Trusts "associations" within the meaning of the Act. It corresponds in every way to the definitions of association referred to by Mr. Justice Sanford in the quotation, *supra.* The fact that *Hecht* v. *Malley* arose under the excise-tax provisions makes no difference. The word "corporation" as defined in the act applies to the entire act, and there is no ground whatever for believing that it meant one thing in one portion of the act and something different in another portion.

But it is contended that because the Texas courts treat such associations as this as partnerships, it is exempted from the effect of Section 1 of the Act by Section 218 (40 Stat. 1070):

> That individuals carrying on business in partnerships shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. * * *

This presents no difficulty, however. As the word " association " appears to be used in the act in its ordinary meaning (*Hecht* v. *Malley, supra*), so also do the words " individuals carrying on business in partnership." The ordinary meaning of the words " individuals carrying on business in partnership " refers clearly to partnerships in the ordinary sense of the word and not to such organizations as the Burk-Waggoner Oil Association. Aside from the individual liability of the stockholders, which, in spite of their efforts to avoid it, the courts of Texas would probably impose, this association is lacking in the essential elements of the ordinary partnership, such as dissolution upon the death of a member, lack of power of members to bind the other members, or to dispose of their interests and foist upon the partnership new members. On the other hand, with the exception of a charter granted by the State, it possesses almost

every element of a corporation. It has a fixed capital stock divided into shares represented by certificates, transferable only upon the books of the corporation, and traded in generally by the public; its affairs are managed by a board of directors with the ordinary corporate officers. It had by-laws which could be adopted by the directors or by the stockholders. There were provisions for regular and special meetings of the stockholders, the directors were removable by the stockholders, and the ultimate power was in the stockholders. Without enumerating with more detail, it was " a body of persons organized for the prosecution of some purpose, without a charter, but having the general form and mode of procedure of a corporation," and it had by the statutes of Texas the right to sue and be sued in its association name. It was such an association as was described by Chief Jutice Knowlton in *Hussey* v. *Arnold,* 185 Mass. 202, as follows:

> The agreement creating the trust has peculiar provisions. The object of it, apparently was to obtain for the associates most of the advantages belonging to corporations, without the authority of any legislative act, and with freedom from the restrictions and regulations imposed by law upon corporations.

It was an association of the kind considered by the Supreme Judicial Court in *Opinions of Justices,* 196 Mass. 603, when that court advised the legislature that it had power to enact a law im-

posing a tax on the sale of their certificates. Justice Rugg in his opinion said:

> The device of voluntary unincorporated associations, with complicated contractual provisions for the transfer of fractional interests therein by certificates, depending for their validity upon an elaborate and intricate trust agreement, for the enforcement and interpretation of which resort is frequently and necessarily had to the courts, does not belong to that class of natural rights which is above the power of the legislature.

It was upon associations of this kind clearly that the Revenue Act of 1918 imposed the excess profits and excise taxes.

Nor does the provision of Section 335 of the act (40 Stat. 1095) cast any doubt upon this contention. Paragraph (c) of that section, a part only of which is quoted in the brief of plaintiff in error, is as follows:

> (c) If a partnership or a personal service corporation makes return for a fiscal year beginning in 1917 and ending in 1918, it shall pay the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917, which the portion of such period falling within the calendar year 1917 is of the entire period.
>
> Any tax paid by a partnership or personal service corporation for any period beginning on or after January 1, 1918, shall be immediately refunded to the part-

nership or corporation as a tax erroneously or illegally collected.

This section appears under "Part VII—Miscellaneous" of the act. It is to be remembered that the taxes imposed by the act were to cover the *calendar year* 1918, although the act was not passed until 1919. This section made provision for an apportionment of the taxes of corporations, partnerships, and personal service corporations making returns for a *fiscal year* beginning in 1917 and ending in 1918.

Both the Act of March 3, 1917 (c. 159, 39 Stat. 1000), and the Revenue Act of October 3, 1917 (c. 63, 40 Stat. 300), imposed excess-profits taxes on corporations and partnerships, and the latter Act defined the term "corporation" as including joint-stock companies and associations. (See *LaBelle Iron Works* v. *United States,* 256 U. S. 377, 384, 387.) The Act of 1918, however, while continuing the excess-profits tax upon corporations other than personal-service corporations, including associations and joint-stock companies, did not impose it upon partnerships. A line was drawn between ordinary corporations, including associations and joint-stock companies on the one hand, personal-service corporations and ordinary partnerships on the other, and inasmuch as its provisions were retroactive to cover the calendar year 1918 it was proper to provide for an apportionment of the taxes of such taxpayers as had

paid upon a fiscal year beginning in 1917 and ending in 1918. This was the purpose of Section 335.

There is no inconsistency or ambiguity in these provisions of this Act.

II

The case presents no substantial constitutional question to sustain the jurisdiction of this court by direct writ of error

It is obvious that there is only one real question in the case: Is the Burk-Waggoner Oil Association to be classed as an association or joint-stock company or as a partnership? That is, of course, not a constitutional question. The petition alleged (R. 3) that the collection of the tax was unconstitutional "in that the said tax is not based upon income and is not in proportion to the population" and that in so far as the collection purported to be based upon official regulations, "it is unconstitutional in that such regulations are beyond the power of the Secretary of the Treasury to promulgate and are beyond the power of Congress to authorize." These allegations at this date raise no serious constitutional question:

Brushaber v. *Union Pacific R. R.*, 240 U. S. 1.

American Sugar Refining Co. v. *United States*, 211 U. S. 155.

It is further alleged that the individual members of the Burk-Waggoner Oil Association had by the collection of the tax been subjected to

unlawful and unconstitutional taxation because such taxation was "not authorized by the Revenue Act of 1918 or any other act, and that if it should be held that such taxation was authorized by said act, then that the act is unconstitutional and contrary to the Fifth and Sixth Amendments."

The court below disposed of the first contention (R. 11) by merely citing the Sixteenth Amendment and the cases of *Brushaber* v. *Union Pacific R. R.*, 240 U. S. 1, and *Realty Co.* v. *Anderson*, 240 U. S. 115, and found it unnecessary to consider the second for the reason that the stockholders, for whom the plaintiff was solicitous, were not parties to the litigation, and that the question of the constitutionality of the statute could be raised only by one who alleged that the unconstitutional features injured him, citing *Panama R. R. Co.* v. *Johnson*, 289 Fed. 964. (R. 12.)

The constitutional question, as raised in this Court, may be stated in its last analysis in this way: If the Act be construed as classing with corporations organizations which are in fact partnerships, and imposing upon them the same measure of taxation, it is unconstitutional because Congress has no power to impose income taxes upon partnerships. In other words, if the Act in so many words had imposed the same tax upon "corporations, associations, joint-stock companies, and partnerships," it would have been unconstitutional.

We submit that this contention is wholly unsubstantial. As already pointed out, the Act of October 3, 1917, did impose the war excess-profits taxes upon corporations, including therein joint-stock companies and associations, and also upon partnerships. The excess profits provision of that act was sustained in *LaBelle Iron Works* v. *United States,* 256 U. S. 377, although this precise question was not raised.

After the exposition in *Brushaber* v. *Union Pacific R. R.,* 240 U. S. 1; *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103; and *Realty Co.* v. *Anderson,* 240 U. S. 115, of the power of Congress to impose income taxes since the Sixteenth Amendment, it would seem as if that question had been finally laid at rest.

We submit that the Court may well decline to entertain jurisdiction of this case upon the familiar line of authorities, some of which are cited *supra,* page 2.

CONCLUSION

The judgment should be affirmed or the writ dismissed.

William D. Mitchell,
Solicitor General.

Alfred A. Wheat,
Special Assistant to the Attorney General.

October, 1925.

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